

Press release

LCQ15: Movements in interest rates

Wednesday, November 19, 2008

Following is a question by the Hon Frederick Fung Kin-kee and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 19):

Question:

In response to a reduction in the federal funds target rate by the Federal Reserve of the United States (US), the Hong Kong Monetary Authority (HKMA) announced on the 30th of October this year a downward adjustment of the Base Rate to a historic low of 1.5%. Yet, for several times this year, the local banks did not follow the downward adjustment of the Base Rate and reduce their prime rates accordingly, and those in the banking industry have even pointed out that there is no room for rate cuts, and it is not until recently that a few banks made a 0.25% rate cut. In this connection, will the Government inform this Council:

- (a) of the trends of the US federal funds target rate, HKMA's Base Rate and the prime rates of local banks, and their differentials in the past five years;
- (b) whether it knows the reasons for local banks not following the Base Rate to reduce their prime rates accordingly; whether it has assessed the impact of such practice of local banks on the financial system, including whether it will trigger arbitrage trading on the interest rate differential between the Hong Kong dollar and the US dollar and undermine the stability of the linked exchange rate system; if it has, of the assessment results; if not, the reasons for that;
- (c) of the measures to urge local banks to adjust their prime rates in line with the level and pace of the Base Rate adjustments; and
- (d) whether it will consider refining the linked exchange rate system to guard against any possible attacks and alleviate the difficulties of enterprises to raise funds, so that rate cuts can serve the purposes of stimulating the economy and

easing the public's burden of repaying mortgage?

Reply:

President,

Details of the trends of the US federal funds target rate (FFTR), HKMA's Base Rate and Best Lending Rates (BLRs) of local banks, as well as their differentials in the past five years, are shown in the diagram attached.

As can be seen from the diagram, movements in BLRs of local banks in the past five years in general followed those in FFTR, with occasional deviations and time lags. For example, during the period from June 2004 to February 2005, BLRs of local banks did not follow the increase in FFTR, reflecting ample interbank liquidity on the back of capital inflow. It was not until mid-2005 that local banks started catching up with the increase in interest rates, with an extent larger than the hike in FFTR during the same period. From September 2007 to March 2008, BLRs of local banks followed the decline in FFTR, though the extent of decline was sometimes 25 basis points less than that in FFTR. While major local banks have recently lowered their BLRs by 25 basis points, they did not follow the US in cutting rates on April 30, October 8 and 29, 2008.

As regards HKMA's Base Rate, it has all along been automatically tracking movements in FFTR according to a pre-set formula. Prior to October 9, 2008, HKMA's Base Rate was 150 basis points above FFTR at most times. HKMA adjusted its formula for calculating the Base Rate on October 9, 2008. From then on, HKMA's Base Rate has been 50 basis points above FFTR.

Deposit and lending rates are commercial decision for banks. These rates are determined not only according to the US interest rates but also the external environment and monetary market condition of Hong Kong. Since early this year, while the Federal Reserve has lowered FFTR many times, the US and Hong Kong dollars interest rates have stayed high owing to the seizing up of local interbank market as well as banks' unwillingness to lend money for fear of credit risk.

HKMA has been closely monitoring the operation of the local banking

sector. Under the Linked Exchange Rate system, interest rate arbitrage activities are mainly driven by the differential between Hong Kong and US dollars interbank interest rates instead of that between Hong Kong and US dollars deposit and lending rates of banks. At present, Hong Kong dollar interbank interest rates are roughly at the same level as their US counterparts, constituting no incentive for interest rate arbitrage activities. Even if there were a spread between the two interest rates, interest rate arbitrage activities will not be as active as they have been under normal circumstances due to market concern about credit risk as well as inclination of market players to deleverage and reduce risk. All market operations conducted and other measures taken by HKMA are in strict accordance with the Currency Board principles. Therefore, the stability of the exchange rates will not be adversely affected.

Given the situation of the global financial market, central banks of different economies have recently introduced a number of measures in a co-ordinated manner. With these measures in place, the US dollar interbank interest rates have gradually eased. HKMA has also injected liquidity into the Hong Kong banking system many times in the light of Hong Kong's condition and put in place five precautionary measures (including subsequent further refinements) to ease the pressure facing local banks. With the implementation of these measures, Hong Kong dollar interbank interest rates have gradually eased alongside the US dollar rates, allowing local banks to lower their commercial interest rates. On November 7, 2008, major local banks reduced their BLRs by 25 basis points.

HKMA will continue to closely monitor developments in the market and put in place necessary measures as appropriate, with a view to maintaining orderly and smooth operation of local interbank market and facilitating banks to continue to effectively discharge their lending function, so that normal operations of enterprises and Hong Kong's economic development can be maintained.